

ICPS newsletter

Economic growth in Ukraine: Problems and risks

A new issue of ICPS's Quarterly Predictions journal will be published this week. According to our forecast, Ukraine's economy will maintain its high growth rate in 2001 and 2002. In these years, GDP will increase by 5% and 5.5%, respectively. Quickly rising domestic demand and increased productivity will make up for the downward trend in foreign markets. The key issues for investors will be effective economic policy, political consensus, and inflation control

In Q4'00, economic growth in Ukraine continued accelerating. According to our estimate, real GDP in Q4'00 increased by 6.5% compared with the same period in 1999. The increase was mainly due to industrial growth and a farming boom.

In 2000, overall GDP growth in Ukraine totalled 6%. The financial stability and predictable government policy prompted an increase in household consumption and business investment. The particularly favourable conditions in foreign markets promoted increased exports.

In our opinion, the high 2000 growth rate increased the confidence of Ukrainian businessmen. They will aim to achieve even greater profits in upcoming years. Active investment needed to accomplish that will promote increased productivity.

Based on these factors, we forecast that the high growth rate in the Ukrainian economy will stay in 2001 and 2002. GDP will increase by 5% in 2001 and by 5.5% in 2002. The slower pace in 2001 and the quicker one in 2002 will reflect the trend in the global economy.

Below we will examine new problems and risks that have changed our view of the economic environment in 2001 and 2002 over the last three months.

Quality of government policy

Ukrainian government decisions became more consistent in 2000. The government began to use new procedures in its work. The obvious result was 31% fewer Cabinet resolutions and decisions in 2000, including 57% fewer orders.

Government committees flushed out inconsistent drafts. Approving decisions only at Cabinet meetings ensured that decisions were in line with the government's declared priorities.

Will there be a further improvement in government efficiency in Ukraine thanks to better enforcement? There are some reasons why the answer is not wholly positive:

- The consideration of practicable policy alternatives has yet

to become a mandatory procedure at Cabinet decision-making meetings.

- Decisions approved do not usually have an enforcement plan that could foresee the reaction of the various stakeholders, and how the government should respond.

- The government lacks procedures for monitoring implementation and assessing effectiveness.

These weak points show themselves clearly in the tax code situation. In early 2000, the government's draft tax code envisaged drastic tax cuts. But no practicability analysis was made at the time, and as a result, the code, which had been approved in the first reading, must now be revised to prevent significant budget losses. Such inconsistency can make tax policy a risk factor for companies taking business decisions.

In addition, weak enforcement of economic policy undermines investors' confidence in Ukrainian reforms.

Political consensus

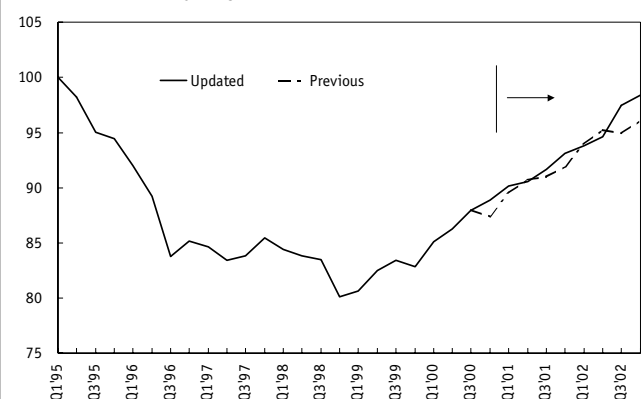
Political instability has been another reason for the lack of investor confidence in Ukraine. Firstly, it jeopardises the consensus between the executive and the legislature on reforms that was achieved in 2000. Secondly, it results in delaying the passage of key legislation (in particular, a new reading of the Civil Code) through the Verkhovna Rada.

At the same time, the political discussion that is now going on in Ukraine may promote some positive changes:

- creating conditions for implementing the basics of public

Real GDP

Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee; calculations and forecast by Quarterly Predictions.

policy: public balancing of policy goals, and strategies of various political groups;

- increasing transparency of interaction between government bodies;
- stricter accountability of government agencies, with the procedure already begun to put the State Tax Administration and customs under the Ministry of Finance's supervision.

Financial stability

Can inflation be reduced substantially in 2001 and 2002?

Reducing inflation and replenishing NBU monetary reserves were set as Ukraine's medium-term economic goals in the letter of intent to the IMF. But these are largely mutually exclusive goals. In our opinion, in 2001 and 2002 the NBU will focus on replenishing its reserves, which means extensive purchase of exchange. This will make impossible any quick reduction of inflation.

Raising productivity will be another key factor in decreasing inflation. For example, a productivity increase in agriculture would cut price shock risks stemming from the deficit of farm produce.

NBU's purchase of exchange will keep the hryvnia losing its nominal value at a reasonable rate. We do not foresee any material fluctuations of the exchange rate during the forecast period. The high inflow of exchange will make a fall of the hryvnia unlikely. There will be a certain risk of revaluation at the moments of peak proceeds from privatisation.

Market conditions

According to our forecast, a much higher domestic demand in 2001 will make up for the somewhat worse conditions in foreign markets. A December 2000 consumer poll gives proof to this prediction. It showed that consumers had much better expectations for 2001. This means that there will be a higher demand for domestic products, as a large part of the high hopes comes from the less-well-to-do Ukrainians.

For export-oriented sectors, demand will be smaller in 2001 than in 2000. We nevertheless predict that the new owners of these sectors' privatised enterprises will insist on investing in order to ensure long-term competitive ability on export markets. If they do, the increased volume of Ukrainian exports will make up for the losses caused by its lower prices. The risk of this forecast is worse-than-predicted conditions in foreign markets, which could be caused, in particular, by U.S. economy's crash landing or Russia's recession.

According to our forecast, the global economy's growth will accelerate again in 2002. The ability of Ukrainian enterprises to quickly adapt to changing external demand will reflect in the quality of investments made in 2000 and 2001. Exports will grow, but import growth will outpace it, bringing trade balance down. ■

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Major indicators

	1999	2000 (estimate)	2001 (forecast)	2002 (forecast)
Economic activity				
GDP, millions UAH	130,038	175,900	212,400	254,300
Real GDP, apc*	-0.3	6.0	5.0	5.5
Real industrial production, apc	4.3	12.9	8.0	8.0
Real agricultural output, apc	-6.9	7.6	4.2	5.8
Gross investment, % GDP	19.8	18.8	19.6	20.7
Direct investments, millions USD (1)	489	580	1,200	1,300
Real household disposable income, apc	1.2	11.1	6.5	7.0
Real retail turnover, apc	-4.8	7.5	6.0	5.0
Prices				
Consumer price index, apc	19	26	17	14
Producer price index, apc	16	21	16	12
Labour market				
Population, millions	49.7	49.3	49.1	48.9
Real wage, average apc	-6.0	1.0	2.5	3.0
Official unemployment rate, %	4.3	4.2	5.5	7.0
Foreign economic activity				
Exports of goods&services, apc	-7.9	15.0	4.0	5.0
Imports of goods&services, apc	-19.1	12.0	7.0	6.5
Current account balance, % GDP	2.7	0.8	0.5	0.3
Budget				
Revenues (consolidated), % of GDP	25.3	27.5	26.0	25.5
Current balance, % GDP	-1.5	0.5	0.1	0.1
Balance by IMF methodology, % GDP	-2.4	-1.2	-2.6	-2.2
Monetary indicators				
Monetary base, apc	39	39	22	19
M3, apc	41	45	30	22
NBU international reserves, millions USD	1,094	1,539	2,100	2,730
Official exchange rate average annual, UAH/USD	4.13	5.44	5.63	5.86
Interest rate on loans, average annual, yearly % (2)	53	41	33	29
International				
World GDP, apc	3.3	4.7	3.4	3.9
GDP of Ukraine's major trading partners (2/3 of exports), apc	3.0	5.8	3.8	4.3

* apc = annual percentage change

Notes:

(1) according to NBU

(2) commercial banks loans, hryvnias

Sources: State Statistics Committee, NBU, and Finance Ministry; calculations and forecast by Quarterly Predictions.